RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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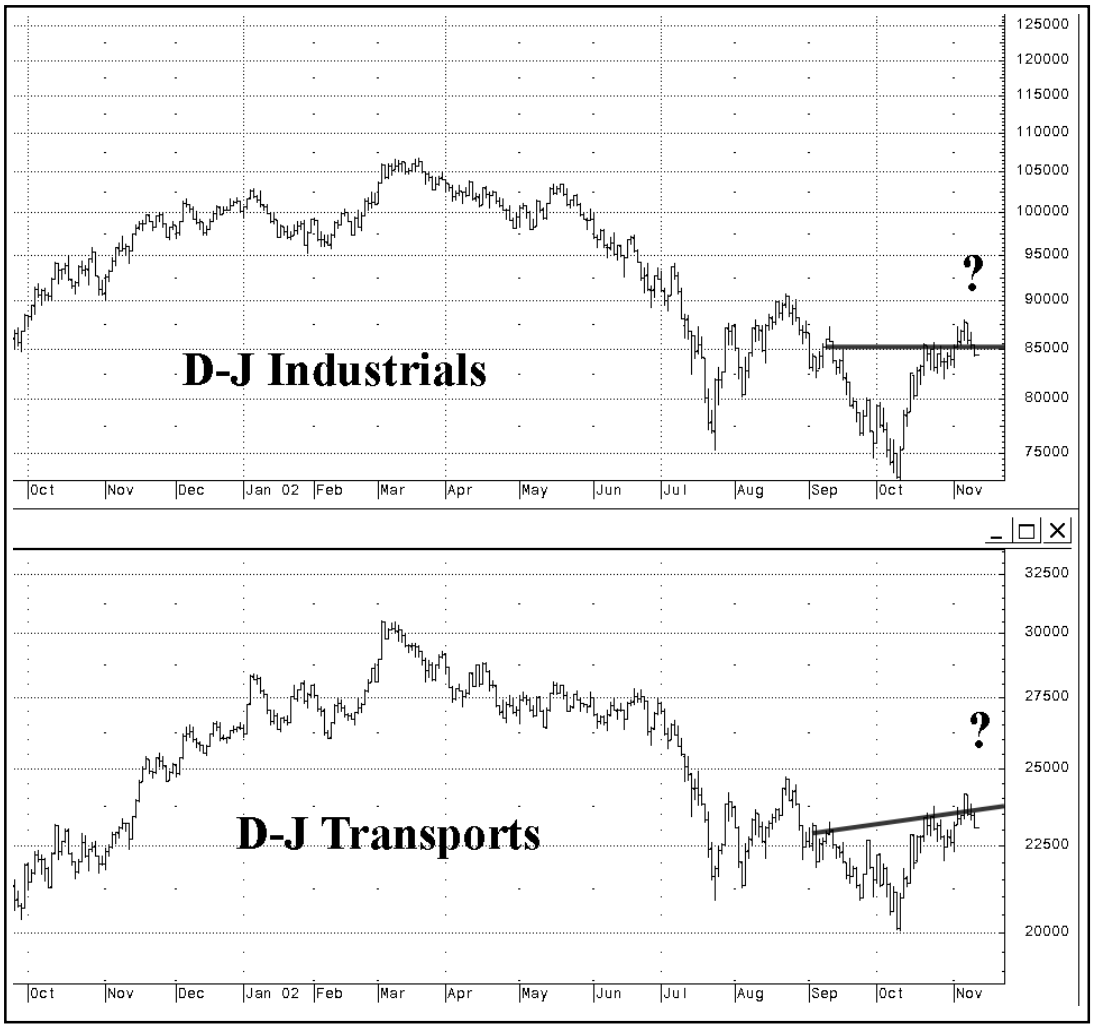
LETTER 1344

November 14, 2002

Oct. 25, DJIA 8443.99; PTI 5227; A-D Ratio -4.75
Nov. 1, DJIA 8517.64; PTI 5229; A-D Ratio -4.19
Nov. 8, DJIA 8536.99; PTI 5238; A-D Ratio -4.98
S&P Yield: 1.77% S&P p/e: 33.46
Gold 50-Day MA: 319.10

WHERE ARE WE? Let's start with some basic Dow Theory. Here we see the D-J Industrial Average compared with the Transportation Average. Note that both Averages came down to July lows, then rallied. But on a test of the July lows, both Averages broke below their July lows only to halt at their declines in October.



The October 9 lows appeared to be a viable bottom. Note also that both Averages have formed what appear to be "head-and-shoulder bottom" patterns. Normally, this should call for extended rallies, rallies that should take the Averages at least above their August highs.

Of course, formations such as a head-and-shoulders bottom play no part in classic Dow Theory. Dow Theory deals strictly with preceding high or low points, and whether the Transports and the Dow both better preceding points – or whether disparities or non-confirmations exist.

On November 7 the market declined, and this gives

us a chance to gauge the strength or weakness of the market. It's what occurs AFTER this sell-off that is critical in judging the market's strength or weakness.

Following the November 7 decline, if both D-J Averages recover to new highs we'll have the "all clear" signal, a signal which will tell us that the market is going higher. However, if one or both Averages fail to recover to new highs, that will be a warning flag that tells us that this market is running into trouble.

It will be most important for the Averages to continue rising out of their head-and-shoulders bottoms. Often, when an important bottoming formation fails, such action tells us that there is something drastically wrong in the price structure. I've never liked a clear "bottom pattern" that forms – and then self-destructs. That kind of action always smells of informed distribution to me.

SUNDRY QUESTIONS AND ANSWERS

Question — Russell, you bought heavily in municipal bonds. What are you going to do with these bonds as the bear market moves on?

Answer – I'm going to keep them. Here's my thinking. The munis were yielding 5.25% when I bought them. That's worth over 9% to me because the interest is tax-free, fed and state. In three years that means what I collect is worth at least 16% before compounding. If a worst case comes along and the AAA-rated bonds that I bought drop say 15% to even 20%, I'm still OK and aside from no total return, at least I break even. But if the bonds drop by 20% stocks and almost everything else gets hit, I'm still better off with muni bonds throwing off 5.25% in non-taxable interest.

Question – Where do you see the Dow going before this bear market is over?

Answer – One thought has been on my mind, and I haven't written about it. The 1921-29 bull market started at a low of 63.90 in August of 1921. The great 1929-32 bear market ended in July of 1932 with the Dow at 41.22. Thus the great bear market ended with the Dow below the level at which the preceding bull market started.

And I wondered, what if this bear market ends with the Dow below the level at which the preceding bull market started? If you believe the bull market started in 1982, then you're talking about a bear market low below Dow 776. If you believe the bull market started in 1974, then you're talking about a Dow below 577. Unthinkable, yes, but in this business anything can happen. And nothing is unthinkable.

Question – I note that a number of analysts are now saying that October 9 was THE bottom for this bear market, and that the worst has been seen. Do you think that's true?

Answer – The most fundamental thesis of Dow Theory is values. George Schaefer, probably more than any other Dow Theorist, stressed values.

A major problem of investors has been the fraudulent earnings that have been posted by so many corporations. The reason for this has a lot to do with options. Because so many executives' perks were tied to options, the various executives did whatever they could get away with – to boost earnings which in turn would boost the price of their company's stock price.

The whole process was disgraceful. But a new thesis has arrived. "Too big to prosecute." The fear is that if many of these companies are prosecuted on the basis of deceitful earnings, then there will be trouble in the form of additional lay-offs.

We've already seen the thousands of lay-offs brought on by the prosecution of Enron. The word is that "we don't want any more lay-offs, so lay off the big corporations." Thus a great deal of the deceit on corporate earnings will go unpunished and never even be brought to light.

But to get back to the original question, no, I don't think the bear market is over. Far from it. The bigger the bull market, the more there is to correct, and a bear market always corrects the excesses of the previous bull market. To put it bluntly, the bull market that ended on September 23, 1999, contained more excesses than any other US bull market in history. Thus, I believe that the bear market we're in will, in time, generate the greatest losses of any bear market in US history.

S&P has come out with their new "core earnings" which shows S&P earnings taking into account option expenses and pension liabilities of corporations. S&P's core earnings for the S&P 500 comes in at a shocking $18.48 in trailing earnings. On this basis, the true price/earnings for the S&P is an astoundingly high 48. Want to be more conservative, use *Barron's* P/E of 33 for the S&P. So considering that at previous bear market lows, the S&P sold for 6 and 7 times earnings, I'd say that this market is still flagrantly overvalued and not near a bear market bottom.

Question – Russell, let's say you're right about this bear market, and it's going to take the Dow down to around 3000 or less. What should we do to preserve our buying power?

Answer – This is probably the toughest question I've had to deal with. I'll give you my best answer. I guess if your main concern is safety (rather than income) your best bet is as follows – one third in T-bills, one third in short-term Euro CDs and one third in gold, the metal. This is about as safe as I can conceive of, but it's not a portfolio that brings in any income.

Question – I note that some analysts are comparing the US today with Japan 10 years ago as their bubble was popping. Do you agree with that appraisal?

Answer – There are certainly a lot of painful similarities. A main difference is that the US is much more flexible than Japan ever was. And that's a plus for the US. But a minus for the US is that the US is a spending nation whereas Japan is a saving nation. Thus when deflation and hard times hit Japan, the Japanese population weathered the storm rather well. The US, however, is smothering with debt.

The attitude in the US is that "the Fed will take care of everything," or "we're number one in the world, and nothing serious can happen to us." Thus, the US has assumed the single most dangerous stance. It's a stance that I term denial.

This paragraph by Morgan Stanley's Stephen Roach has stuck in my mind –

"America, by contrast (with Japan), remains the land of denial. The latest in a long string of reversals in a bruised and battered stock market is a classic good-feeling tonic. Moreover, we have a defensive central bank that still doesn't want to admit that it could have done anything about the asset bubble. And we have a White House that categorically dismisses the perils of double-dip and deflation as bad things that only happen to others. The focus in Washington is on war, not on navigating the perilous course of a post-bubble economy. Maybe it's not so far-fetched after all to be worrying about being the next Japan."

Question – How do you suggest that I take a position in the gold universe?

Answer – You can buy futures, options, stocks or the actual metal. I suggest buying some gold shares and some gold coins. The lowest premium gold coin is the Krugerrand. When you buy a Kruggie, you're buying an ounce of gold. One advantage of the coin over the mines is that you have no worries about mine earnings, mine disasters, stock market manipulations,

etc. The purest and safest way to participate in the gold picture is via the coins. Gold coins should be kept in a safe hiding place, and preferably out of a bank vault. I can't tell you where to hide your coins, you know your house and your grounds and I don't.

As for the shares, you can buy the big producers such as NEM, ABX, PDG, AU. Or you can buy a collection of the low-priced gold shares, which you can treat as perpetual warrants. The question – which should I buy? I'd buy a selection from both. Or you can buy just the low-priced gold figuring this way – if gold takes off on the upside big time, these stocks can double and triple and double again. Furthermore, when you buy a gold share for two dollars, the most you can lose if all goes bad is – well, it's two dollars.

For my average subscriber, I don't advocate going the futures or options route. When you buy a future or an option you are playing against time. You buy gold for insurance. I don't want my gold insurance to be limited by a given time.

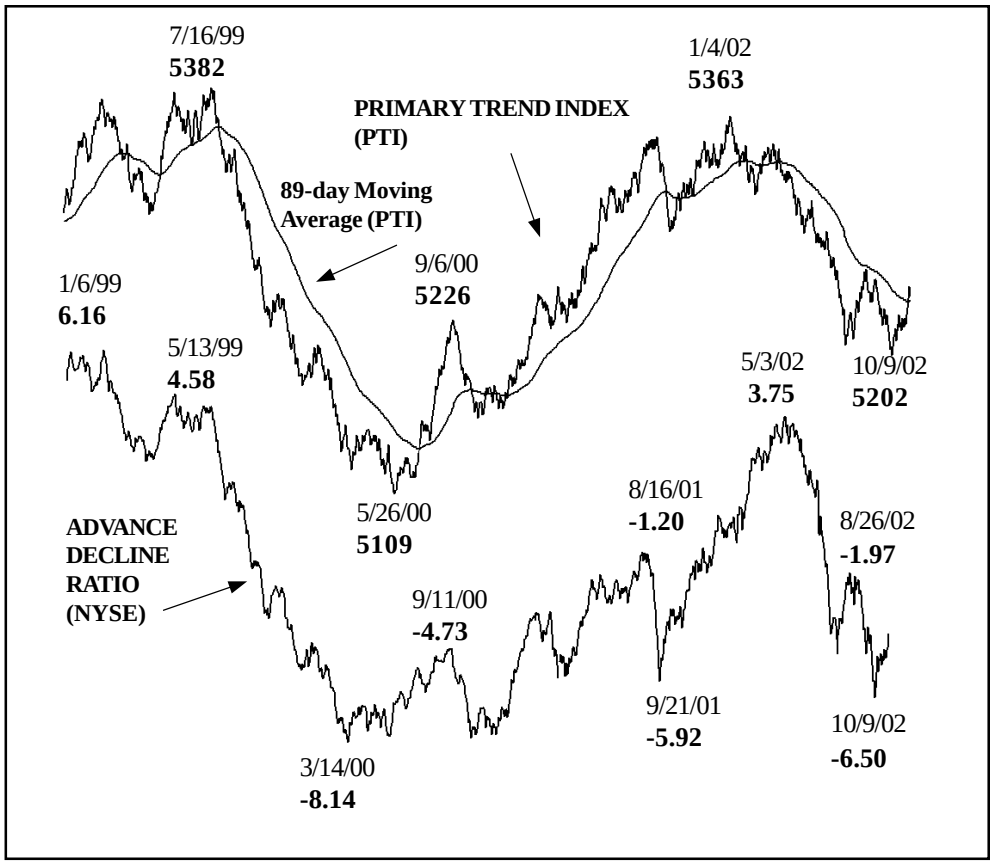
PTI and ADVANCE DECLINES – On November 5, for the first time since early April, my PTI crossed above its 89-day moving average. Thus, the PTI turned bullish for the first time in seven months.

I took this as confirmation that the near-term trend of the market remained bullish. For those who got on my daily site, this meant that our speculative purchases of the Diamonds (DIA) have a chance of generating some decent profits for us. The Diamonds, of course, are the Exchange Traded Funds that represent a proxy for the Dow. The Diamonds move up or down in lock-step with the Dow.

I suggested that subscribers buy the Diamonds when the Diamonds were in the 79-80 level. As I write the Diamonds are selling at around 86-87. DIAs are traded on the Amex as though they were any other stock. My logic in suggesting that subscribers buy the Diamonds instead of trying to pick the four or five stocks that you hope will beat the averages is this – we're still in a bear market. Trying to pick winning stocks in a bear market is extremely difficult.

It is almost impossible to visualize the stock market going higher without full participation or probably leadership by the Dow. The Dow is usually at the forefront of advances and the last to get hurt by a decline.

Turning to the advance-decline ratio, this has been the weak area of the advance from the October low. The advance has been characterized by sluggish breadth and the total absence of anything resembling the much-desired "breadth thrust." In fact, it's been a long time since I've seen an advance of this amplitude in the averages accompanied by such unimpressive breadth.



Confirming the weak breadth has been the dearth of new highs on the NYSE. The lack of new highs simply tells us that few stocks are "breaking out" of their patterns. What we've been seeing is mainly pullbacks on the part of stocks that have been hurt.

So the big question is, "Can the rally continue, even though breadth is lagging? And the answer is yes, but thin-breadth rallies tend to be fragile, even dangerous rallies. They are rallies that must be watched closely.

INVESTMENT POSITION – The bear remains in the box. He's liable to make the box his home for a long time. In bear markets, the operative concept is – "Try to avoid losses." And trading does tend to produce losses. In my experience, the more you trade in a bear market the better the chances that you will sustain losses.

The second operative concept is – **COMPOUNDING**. How to compound? The first way to compound is to pick the most conservative securities, which at the same time produce the best return. This includes top-grade bonds, the best preferred stocks and money market funds or CDs. The idea is to build a portfolio that throws off cash.

The second way to compound is to save. You may not have saved up to now; you may have built up a lot of debt. But I can assure you that in a bear market your best move is to cut down on expenses and save. Then you place the money you've saved into safe vehicles that throw off cash and compound your income by buying more safe vehicles.

"Safe vehicles" include top-grade bonds, top-grade preferred stocks, CDs and well, cash. And of course, some gold. A number of utility preferreds offer yields of 6% and more, and I consider these preferreds quite safe.

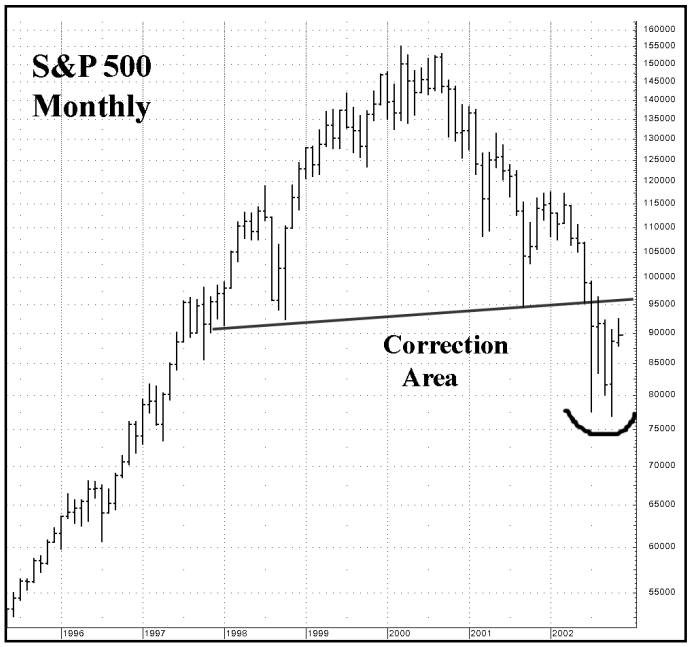
Compounding requires discipline, patience and an understanding of the power of compounding.

COMPUTERS – We have about half of our 8,200 subscribers who still want hard (paper) copies of the Letter mailed to them – and we oblige. I don't know how many of you "paper copy subscribers" don't use a computer, but I'm guessing about 2,000.

Those of you who are not on the Internet and therefore don't see the daily stuff that I write are really missing a lot. First of all, the remarks that I write six days a week will keep you abreast of this fast-moving market. I talk about stocks, bonds, gold, tactics, strategies, and the economy – all this every day. If you are not receiving these daily comments you're just not getting your money's worth.

Look, I'm an ex-New Yorker, and we're famous for being totally unmechanical. If I can learn to operate a computer at my tender age of 78, anybody and everybody should be able to work with a computer. My 74 year-old little sister bought a machine (not a computer) which was inexpensive and which gets her on the Internet and also allows her to send and receive e-mails.

So c'mon, you old fuddy duddies, go out to your local computer store and buy something that will get you on the Internet. Let's go; let's get into the 21st century. You can do it. If Richard Russell can do it, you can too. I work my tail off writing every day – and I want you to get the maximum value for your subscription price.



CHARTS– I'm again showing the monthly chart of the S&P 500. Here we see the massive "head-and-shoulders top" that has formed, probably the largest and most formidable top in stock market history. In July the S&P broke below the horizontal support line (the "neckline") of the formation. Following the July break, the S&P plunged to an October 9 low of 776.76. From the October 9 low, the S&P rallied to correct some of the severe damage it had sustained (by October 9 the S&P had lost over half its peak value).

You can see that the S&P has now rallied almost to the horizontal resistance area. The obvious question is whether the resistance will basically halt any further upward progress by the S&P. Why guess? Let's see how much power is left in the corrective process.

I will say this – I believe most of the advance from the October 9 low is a product of professional speculators, short covering and a very limited amount of buying by the retail public. I don't get the impression that there's been any real institutional buying. Without participation by the "big boys," I'm rather skeptical regarding how much higher this correction can carry.

Gold – Watching the daily action of a stock or a group can be deceptive. Often you can't see the forest for the trees. A weekly chart can help you in identifying the true, underlying trend.

I show here a weekly ratio chart of gold. Note that since January of 2001 gold has been climbing up a well-defined channel. Actually, since April of 2002 gold accelerated and during June and July gold surged above the channel's upper boundary. This brought about the correction to the July low. Since July gold has resumed its climb, and right now gold has again approached the upper limits of its rising channel.

From my standpoint as a "gold-bug," I'd be just as happy if gold remained in its rising channel rather than surging above the channel again and becoming overbought. The higher gold can climb without attracting undue attention, the better for the yellow metal. Somewhere ahead, it could be a few months or a year gold is going to become speculative.

Gold is still in its accumulation phase. There is very little interest from the public or the funds in gold or gold shares. This will change drastically as, somewhere ahead, the gold bull market turns speculative and as "everyone" wants a piece of the action in gold (this, unfortunately implies a flight from paper "legal tender").

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